

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Alpert Analyst: Marion Mann DeJong Bill Number: SB 304

Related Bills: _____ Telephone: 845-6979 Introduced Date: 02/04/1999

Attorney: Doug Bramhall Sponsor: _____

SUBJECT: Combined Reporting/Top Tier Corporations of Commonly Controlled Groups/Regulated Public Utility Group

SUMMARY

This bill would allow "top tier" corporate taxpayers to elect to include all the income and apportionment factors of the members of a designated regulated public utility group (as defined) in a combined report, regardless of whether the group members are unitary. This bill also would define "unitary business" for a non-electing regulated public utility group as one whose business activities show operational interdependence (as defined), strong central management (as defined), or a qualified holding company relationship (as defined).

EFFECTIVE DATE

This bill would become effective on January 1, 1999. This bill specifies that the first designated income year for an elective combination cannot begin before January 1, 1999.

LEGISLATIVE HISTORY

AB 417 (1997), AB 601 (1997).

SPECIFIC FINDINGS

The California Bank and Corporation Tax Law (B&CTL) requires unitary corporations with activities both within and outside California to combine all activities when determining business income apportionable to the state for tax purposes. Under the worldwide unitary method, the income of related affiliates that are members of a unitary business is combined to determine the total income of the unitary group. A share of the income is then apportioned to California on the basis of relative levels of business activity in the state, as measured by property, payroll, and sales. The California income is then apportioned to the members taxable in California, which each retain a separate tax identity and liability.

The B&CTL allows corporations to elect to determine their income on a "water's-edge" basis. Water's-edge electors generally can exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources.

Board Position:

<u> </u> S	<u> </u> NA	<u> </u> NP
<u> </u> SA	<u> </u> O	<u> </u> NAR
<u> </u> N	<u> </u> OUA	<u> X </u> PENDING

Department Director

Date

Gerald Goldberg

3/16/1999

The basic tests used to determine if corporations are "unitary" in nature are:

1. The three unities test: whether the corporations exhibit unity of ownership or control, unity of operation (as evidenced by central purchasing, advertising, accounting and management divisions), and unity of use in its centralized executive force and general system of operation (Butler Brothers v. McColgan (1941) 17 Ca.App.2d 664); and
2. The contribution or dependency test (Edison California Stores v. McColgan (1947) 30 Cal 2nd 472).

The B&CTL contains bright-line tests to determine unity of ownership. A group of corporations is considered commonly controlled under the following conditions:

- if the corporations are connected by more than 50% stock ownership to a common parent corporation;
- if the same individual or entity holds stock possessing more than 50% of the voting power of the corporations;
- if the corporations are legally tied or bound together ("stapled") entities, as defined; or
- if the corporations are held by members of the same family, as defined.

Satisfying the other tests used to determine whether a corporation is unitary requires a case-by-case analysis of the taxpayers' situation. Factors used to establish whether a unitary relationship is present between two or more corporations include: intercompany sales; centralized management, purchasing and advertising; financing (lending capital between companies); the transfer of information; common pension, employee benefit, and insurance plans; and the sharing of facilities, trade name, trade marks, patents and processes. The importance of each factor may vary depending on the particular case.

Current Franchise Tax Board (FTB) legal rulings provide guidance for determining unitary status of holding companies.

The B&CTL also allows the FTB to permit or require the filing of a combined report or such other information needed to properly reflect income attributable to California by two or more taxpayers controlled directly or indirectly by the same interests, unless a valid water's-edge election is in effect.

The B&CTL provides for the use of an apportionment formula when assigning business income of multistate and multinational corporations to California for tax purposes. For most corporations, this formula is the average of the factors of property, payroll and double-weighted sales. Each factor is the ratio of in-state activity to worldwide activity. The combined report is used to determine the apportionment percentage and the amount of income attributable to California.

This bill would allow a "top tier corporation" to elect to combine the income of all members of a designated regulated public utility group in a single combined report. This election would be allowed even if all members of the group were not part of a unitary trade or business under traditional unitary definitions. Only the top tier corporation could make the election to file a single combined report. If more than one corporation fits the definition of top tier, all top tier members must elect.

"Top tier corporation" would be defined as a parent corporation, which generally means a corporation which owns more than 50% of the stock in another corporation or a brother-sister parent corporation. A brother-sister parent corporation would be a parent corporation in a commonly controlled group where some members of the group are not owned more than 50% by that parent. A top tier corporation also would mean any other member of the commonly controlled group that is not owned more than 50% by a parent corporation. A top tier corporation would not have to be a California taxpayer.

This bill also would define "brother-sister parent corporation," "parent corporation," and "corporation."

This bill would define "designated regulated public utility group" as a commonly controlled group, more than 50% of whose total gross business receipts constitute regulated public utility gross business receipts in the current income year. "Regulated public utility gross business receipts" would be those gross business receipts received by a public utility for goods or services whose rates of charge have been established or approved by a federal, state, or local government agency or governmental agency. A "public utility" would be a business entity or business segment that owns or operates any plant, equipment, property, franchise, or license for the transmission of communications, transportation of goods or persons, or the production, transmission, sale, delivery, or furnishing of electricity, gas, water or steam.

This bill would provide rules regarding the form and length of the election. To initially qualify for the election, the group must constitute a regulated public utility group for the first 12 months of the election period. The election would remain in effect for 84 months and would commence on the first day of the income year designated in the election. The designated income year would not begin before January 1, 1999. If the taxpayer requests and has good cause, the FTB would be able to terminate the election early.

The FTB would prescribe the form and manner for the election, which must be made by all the top tier members before the first day of the designated income year. The election is automatically renewed for another 84 months unless one of the top tier members files a notice of nonrenewal before the end of the 84-month period.

The automatic renewal would not apply if the group did not constitute a designated regulated public utility group for the last 12 months of the 84-month election period. In addition, **this bill** would require FTB to prescribe regulations that would terminate the election if, in any two 12-month periods of the 84-month election period, the regulated public utility gross business receipts of the group subject to the election is less than 40% of total gross business receipts of the group.

This bill would provide that if an election is terminated or not renewed, another election may not be made for any income year beginning 60 months after the last day of the election period that was terminated or not renewed. FTB may waive this rule for good cause.

This bill grants the FTB the discretion to allow perfection of a defective election. This bill does not specify any factors that the FTB should take into account when making its determination of whether to perfect the election.

The statute of limitations would remain open for adjustments resulting from the perfection or voiding of the election for all taxpayers in the group whose income year falls within the 84-month elective period.

For electing corporations, **this bill** would allow all income to be apportioned by a single apportionment formula, modified, if appropriate, by specified regulations. Certain conditions would be imposed for using the special apportionment formulas. Neither the department nor the group members may rely upon the existing law, which authorizes special apportionment formulas, to (1) prevent the income and apportionment factors of a group member from being included in the single combined report or (2) assert that the election has the effect of unfairly reflecting the extent of any group member's activity in California or any other state.

With the exception of certain stock transactions between group members that would be deemed business income, business and nonbusiness income would be determined and treated under existing laws. Regulations also shall prescribe the appropriate accounting adjustments that may be needed to account for a termination or nonrenewal of an election. The income and apportionment factors of a member may not be included in the combined report if other provisions of California law would normally prohibit their inclusion, such as the law which generally prevents Subchapter S corporations from being included in a combined report.

This bill would require the top tier corporations to waive expressly, on behalf of all members, any constitutional objections to the fact or effects of the election.

This bill would specify how the departure of a group member would affect the election. If a corporation other than a top tier member leaves the group, the election would remain valid for the remaining members. If the corporation transfers to another group, that corporation would generally take the elective or non-elective status of the acquiring parent. If a top tier member leaves the group, the rules would vary depending on whether the new group has elected, whether there are other top tier members in the new group, and the remaining length of the election periods for each top tier member.

This bill would provide rules to address certain situations involving corporate organizations, reorganizations, and mergers. Generally, for organizations and reorganizations, **this bill** would have the election remain in effect and any new top tier corporations would constitute electing top tier corporations if the members were subject to the election before the organization or reorganization or were formed to acquire stock or assets which belonged to an electing member. For mergers of top tier corporations, this bill would treat the election of a top tier corporation as a tax attribute under the Internal Revenue Code (IRC), and the electing or nonelecting status of the surviving corporation would be determined by FTB regulations. Designating the election as a tax attribute would mean that the election would be treated as one of a number of items (methods of accounting, depreciation, inventories, etc.) which may vary between two merging corporations and require resolution on which corporation's method should be used by the surviving corporation.

This bill also would provide rules regarding the income and apportionment factors of two or more members that are on different income years and either become subject to an election or are members of an electing group that terminates the election.

This bill would provide rules for taking into account income and factors of new members. Rules are provided to cover when a taxpayer has the same income year as the rest of the group and joins the group in mid-year. These rules also cover situations where the members have or have not filed a combined report in prior years.

This bill would provide special rules for a combined reporting election made in conjunction with a water's-edge election. Through the interaction of this bill and the existing water's-edge statutes, any group which elected both water's-edge and combined reporting would contain all entities required to be included in the water's-edge group and any additional corporations which may be added by the election made under this bill. If any member is already part of a water's-edge group when the reporting election is made, then all taxpayer members shall be treated as part of the water's-edge group and subject to the water's-edge laws. If the reporting election is made first, all members of the group must make the water's-edge election as a single water's-edge group.

This bill would allow a single corporation to elect to file as if all its income were from a single trade or business and would provide rules under which another member becomes part of the single corporation's election.

This bill would allow the FTB to prescribe any necessary regulations to carry out the purposes of this bill.

This bill would specify that group members shall be treated as if they were engaged in a unitary business.

This bill would require top tier corporations filing a single combined report to attach to their tax return a schedule listing all corporations in the commonly controlled group, regardless of whether the income and apportionment factors are properly included in the combined report.

If the top tier corporation fails to attach the schedule, or attaches an incomplete schedule, a penalty of \$1,000 for each corporation not disclosed may be assessed. If a top tier corporation fails to provide the schedule upon notice from the FTB, or demonstrates substantial noncompliance for two or more income years, the penalty is increased to \$5,000 for each corporation not disclosed. The penalty would be waived in whole or in part for reasonable cause and could be assessed against any member of the group.

This bill also would define "unitary business," for members of a designated regulated public utility group that do not make a combined reporting election, as one whose business activities show operational interdependence, strong central management, or a qualified holding company relationship. Thus, this bill would establish a statutory definition of a "unitary business" for regulated public utility groups for which an election to file a single combined report (nonelectors) has not been made.

"Operational interdependence" would be established by a substantial amount of one of the following:

- Intercompany sales of products or services.
- Transfer of technical or marketing information.
- Common distribution systems.

- Coordinated purchases of products or services used in the production of other products or services for sale.
- Advertising and sale of products or services under a common tradename.
- Sales to common customers through coordinated sales activities.

The substantial amount condition would be satisfied if (A) the described activities affect more than 10% of the products or services, separately or in the aggregate, which are purchased or sold by a member, or (B) activities of operational interdependency are essential to the business operations of either party to the operational interdependency.

This bill would provide FTB authority to disregard operational interdependency activities if the purpose of the activities is to create the appearance of a unitary relationship to avoid tax.

"Strong central management" would exist when the major policy and day-to-day decisions regarding the business operations of the corporations under consideration are made by an individual or individuals who are common officers or directors of those corporations. Policy decisions involving capital structure, capital acquisitions, budget approvals or financing would not be sufficient alone to establish strong central management.

A "qualified holding company relationship" would exist when a holding company is an intermediate holding company, a holding company parent to a unitary group, or a unitary asset holding company.

This bill would define "holding company," "intermediate holding company," "holding company parent to a unitary group," and "unitary asset holding company."

In the event that a member of a commonly controlled group is unitary with another member, and that member is unitary with still another member, **this bill** would provide that all of those members constitute members of a single unitary group, even if some of the members do not have a direct unitary relationship with one another. However, if the activity of the member with the common unitary relationship would not be sufficient to combine the other members (if that activity had been conducted as a division of either of the other members), the member exhibiting the common unitary relationship would be treated as unitary with that member to which it has the strongest unitary ties.

Policy Considerations

This bill would raise the following policy considerations:

- This bill would create special unitary treatment for a specific industry, creating disparity for taxpayers in other industries. However, one could argue that Public Utility Commission (PUC) operational restrictions effectively limit, artificially, regulated public utilities from forming unitary combinations due to management and structural restrictions. As a result, elective combination arguably is needed to allow parity for these entities to compete with other entities in the era of deregulation.
- FTB staff has maintained that the PUC operational restrictions do not prevent unitary combination, per se. Rather, they serve primarily as a limitation on the ability to establish unity based upon the strong centralized management test.

In other contexts, it is simply easier to determine the unitary status of public utility companies because regulated public utility companies are subject to PUC documentation requirements that provide clear and complete documentation of the structural and operational facts necessary for a unitary determination.

- Opponents of efforts to statutorily define a unitary business assert that the definition of unitary businesses has evolved through years of litigation and is commonly understood by taxpayers. This bill would provide a definition of a unitary business that could cause new confusion to taxpayers and could cause litigation over new issues.
- It is unclear whether special treatment is warranted for regulated public utility groups in an era of deregulation, since diversification trends make it uncertain for how long the industry will derive the majority of its revenues from the regulated sector.
- This bill would allow regulated public utility groups currently filing as unitary, but which might fail the proposed bright-line unitary test, to file a combined report similar to the federal consolidated return. It can be expected that the top tier members would make this election when it could be used to obtain the best tax advantage. The tax advantage effect of the election is somewhat mitigated by the fact that the election is binding for 84 months and perhaps by taxpayers' electing because of reduced compliance costs.
- A few states accept "consolidated" returns that allow the taxpayers to consider only common ownership when filing. However, no other state has authorized an elective combined filing similar to the election proposed by this bill. This bill establishes unique filing/compliance criteria.

Implementation Considerations

This bill would raise the following implementation considerations. Department staff is available to assist the author with any necessary amendments.

- This bill would allow taxpayers to make an election for income years beginning on or after January 1, 1999; however, the election must be made before the first day of the designated income year. Taxpayers with income years beginning before the enactment date of this bill would not be able to make the election until the next income year, while taxpayers with income years beginning after the date of enactment could make the election for the 1999 income year. In addition, the department would need time to provide instructions for making elections to taxpayers. To provide consistency for taxpayers and for ease of administration, the bill should become operative for income years beginning on or after January 1, 2000.
- This bill would provide for the automatic renewal of an election unless the group did not constitute a designated regulated public utility group for the last 12 months of the 84-month election period. It is unclear whether this would require the department to audit each group prior to renewal to determine if the group is a designated regulated public utility group.

- Many regulated public utility companies invest in tax shelters such as low-income housing limited partnerships. Generally, when a partnership and the partner are not unitary, the distributive share of partnership activities is treated as a separate trade or business. It is unclear how the election works in this situation. Would this separate trade or business be deemed unitary by the election? Does the election provision refer to lines of business or only to separate corporations?
- This bill would provide that if an election is terminated or not renewed, another election may not be made for any income year beginning 60 months after the last day of the election period that was terminated or not renewed. It is unclear when the 60-month period begins: the date of the termination or nonrenewal or the end of the original 84-month election period. Further, this could be read to preclude an election for a period beginning 60 months from the termination or nonrenewal.
- It is unclear whether the **transfer** of technical or marketing information, for determining operation interdependence, means the physical transferring of information or the sharing of information.

Technical Considerations

Technical amendments are provided to do the following:

- Amendment 1 would change a word to its plural form.
- Amendment 2 would change an incorrect reference.

REGULATIONS

This bill would specify that the FTB shall promulgate regulations for specified provisions and may promulgate any necessary regulations to carry out its purposes.

FISCAL IMPACT

Departmental Costs

To the extent that this provision prevents disputes between the taxpayers and the department over whether a regulated public utility group is unitary, cost savings for the department's audit and legal staff may result. The extent of these possible savings cannot be quantified.

Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of SB 304 As Introduced 02/04/99 [\$ In Millions]				
Fiscal Year Impact				
1999-00	2000-01	2001-02	2002-03	2003-04
minor	minor	minor	(\$21)	(\$22)
* Minor reflects a loss less than \$500,000.				

The bill would be effective with income years beginning on or after January 1, 1999, with enactment assumed after June 30. Fiscal-year cash flow impacts reflect the three-year audit cycle that would normally apply in cases where the department would reverse self-assessed liabilities of taxpayers reporting under current combination standards.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The number of investor-owned utility corporations that elect to combine with commonly controlled entities and the resultant reduction in tax liabilities would determine the revenue impact of this bill. Audit data were used to estimate revenue losses attributed to utility companies likely to combine with nonunitary commonly controlled members.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 304
As Introduced February 4, 1999

AMENDMENT 1

On page 3, line 27, strikeout "provision" and insert:

provisions

AMENDMENT 2

On page 7, line 14, strikeout "25101.2," and insert:

25102.2,